

## **IRS SETS NEW AUDIT PRIORITIES**

WASHINGTON -- The Internal Revenue Service is realigning its audit resources to focus on key areas of non-compliance with the tax laws. The strategy represents a new direction for the agency's compliance effort.

Following months of research and planning, the new approach will focus on high-risk areas of non-compliance. The IRS effort will generally focus first on promoters and then on participants in these various schemes. The initiative will feature new and enhanced efforts on several priority areas, including:

- Offshore credit card users.
- High-risk, high-income taxpayers.
- Abusive schemes and promoter investigations.
- High-income non-filers.
- Unreported income.
- The National Research Program.

Increased resources for audits – also known as examinations -- will be devoted to these projects in Fiscal Year 2003, which will be a year of transition and training as new audit cases move into the IRS system.

The IRS Small Business/Self-Employed Division will handle the new effort in these key areas affecting individuals and businesses. Compliance efforts will continue in other parts of the agency, such as the tax shelter initiative in the Large and Mid-Sized Business Division.

This initiative reflects part of a broader, agency-wide plan at the IRS. This strategy places a top priority on pursuing promoters of abusive schemes, shelters and trusts and then identifying participants in these efforts to evade taxes. To address these problems, the IRS has revamped its compliance programs to refocus on problem areas. The IRS will use a full scope of tools and techniques ranging from summons enforcement, injunctions and criminal investigation of promoters to civil audits of participants.

The strategy reflects the new way of doing business at the IRS. Several of these efforts -- such as the National Research Program and the credit card initiative -- reflect innovative approaches to tackle long-standing tax problems. And the agency's reorganization has allowed key parts of the organization to work together in ways they didn't previously. For example, the new audit initiative will include similar emphasis for the agency's collection area. And new levels of cooperation and coordination are underway on initiatives that involve both civil actions and criminal investigation. These illustrate how the new IRS business model better positions the agency to respond to high-risk tax areas.

For the six new areas, the agency will direct more examination resources to address these issues. However, the IRS will maintain a presence in other audit areas to maintain core tax administration responsibilities. Additional exam resources will help meet this requirement.

Key areas for the new initiative include:

## **OFFSHORE CREDIT CARD PROJECT**

It is not illegal to have an offshore credit card. However, there is a reasonable basis for believing that some people are using offshore credit cards to evade paying U.S. taxes. Credit cards provide easy access to offshore funds and accounts in tax haven countries that allow income to be hidden. U.S. citizens must pay tax on their worldwide income.

The IRS has taken several major steps to combat tax-avoidance schemes involving credit cards issued by offshore banks. According to public records:

- On October 30, 2000, a federal judge in Miami issued an order authorizing the IRS to serve John Doe summonses on American Express and MasterCard. These summonses were designed to obtain limited information for 1998 and 1999 revealing U.S. participants in offshore arrangements who hold credit cards issued by banks from Antigua and Barbuda, the Bahamas, and the Cayman Islands.
- On March 27, 2002, a federal judge in San Francisco issued an order authorizing the IRS to serve a John Doe summons on VISA International seeking records on transactions for 1999-2001 using cards issued by banks in over 30 tax haven countries.
- On August 21, 2002, a federal judge in Miami issued an order authorizing the IRS to serve a John Doe summons on MasterCard for records on transactions for 1999-2001 using credit cards issued by banks in over 30 tax haven countries.
- On August 29, 2002, the IRS asked seven courts across the nation (Atlanta, Chicago, Dallas, San Francisco, Seattle, Newark, Alexandria, Va.) for permission to serve John Doe summonses on over 40 businesses to assist in the identification of credit card owners.

The first summons alone yielded data from MasterCard on 237,000 cards issued through 28 banks in three countries. The majority of the cards appear to have been issued to U.S. customers.

If the MasterCard information is representative of the industry, there could be 1 million to 2 million U.S. citizens with debit/credit issued by offshore banks. This compares with only 170,000 Reports of Foreign Bank & Financial Accounts being

filed in 2000 and only 117,000 individual 1040 filers indicating they had offshore bank accounts (tax year 1999).

Credit cards do not equate to taxpayers. The IRS must utilize an extensive process to identify the taxpayer associated with each card. Spending patterns, unusual expenses, proximity of spending and repetitive expenses are all considered in the process.

Once taxpayers are identified from cards, case building begins. The IRS already has developed hundreds of cases for civil audits or potential criminal investigations. The IRS is increasing resources in Fiscal Years 2003-2004 devoted to working these cases.

### **HIGH-RISK, HIGH-INCOME TAXPAYERS**

High-income returns are often more complex and, generally, upper income taxpayers have resources to engage in pass-through entities such as partnerships, trusts and corporations. Even utilizing IRS's various matching programs, income and deductions from such activities are more difficult to verify.

While the IRS has begun to match K-1 forms from pass-through entities, the technique does not provide any verification of income reported by the entity itself. Verifying the income on these returns requires an examination. Starting in Fiscal Year 2003, the IRS will be utilizing a combination of filters to identify high-risk, high-income returns. The returns selected for examination will be those most likely to have unreported income or structured transactions.

A structured transaction is one with limited economic benefit and whose primary purpose is to reduce or eliminate a tax liability. Structured transactions are generally done through one or more pass-through returns, such as Forms 1065 or 1120-S. The pass-through returns create paper losses that flow back to individual income tax returns offsetting income from other sources.

### **ABUSIVE SCHEMES AND PROMOTER INVESTIGATIONS**

IRS efforts to combat abusive schemes and scams (including the Offshore Credit Card Project) will significantly increase from FY2002 to FY2003. Schemes and scams on the rise include:

- **Schemes**, reducing a person's tax liability by claiming inflated expenses, false deductions, unallowable credits or excessive exemptions.
- **Frivolous return arguments**, telling taxpayers compliance is voluntary or the U.S. Constitution does not provide for tax collection.
- **Promotion of slavery reparation claims**, scams that claim compensation for people who have ancestors who were slaves.

- **Abusive shelters and trusts**, investments established for the purpose of hiding income from taxation.
- **Employment tax schemes**, employee leasing, paying in cash and filing false payroll tax returns.

Abusive Scheme Groups are being established in each Area and the use of Fraud Specialists will increase. To identify and address promoter activity, a Promoter Lead Development Center has been created. The Center systematically monitors the Internet to identify promoters of abusive activities and develops cases for injunctive investigations.

## **HIGH-INCOME NON-FILERS**

The IRS efforts to address non-filers in FY 2003 will focus on the most egregious and high-risk segments of the population.

The non-filer strategy will be pursued on many fronts:

- Re-engineered processes and work streams to improve efficiency and productivity.
- Identification and expedited assignment of the most egregious non-filers.
- Expanded and centralized automated enforcement.
- Outreach and education efforts.

## **UNREPORTED INCOME**

Unreported income represents the largest component of the tax gap. IRS has developed a new tool for identifying returns with a high probability of unreported income. The new tool is known as Unreported Income Discriminant Index Formula (UI DIF).

All individual returns have traditionally been assigned a DIF score rating the probability of inaccurate information on the return. The new UI DIF score rates the probability of income being omitted from the return. The IRS has customarily used indirect examination methods to identify unreported income but until now has had no systemic method for selecting the returns at highest risk for unreported income.

UI DIF gives the IRS the ability to systemically identify returns at high risk for unreported income and beginning this fall all returns will receive a UI DIF score in addition to the traditional DIF score.

## **NATIONAL RESEARCH PROGRAM**

National Research Program (NRP) examinations, which begin this fall, will measure reporting compliance and identify compliance issues. NRP will enable the IRS to improve the examination selection process. NRP is very different from its

predecessor, the Taxpayer Compliance Measurement Program (TCMP). NRP no longer relies heavily on time-intensive, “line-by-line” audits for establishing a baseline measure of reporting compliance.

The IRS has not conducted updated research on the distribution of errors on returns for more than 13 years, a period when the economy and the tax law have changed dramatically. Without the information that will be gathered through NRP, the IRS will have less ability to direct examinations and other compliance activities with accuracy and precision. With updated information, the NRP effort will prevent thousands of “no change” audits each year.

The NRP effort will review a small, statistically valid sample of individual returns for tax year 2001, less than 50,000 returns out of 132 million individual returns filed. The new NRP process will have four main categories:

- **No IRS contact.** About 8,000 returns will be checked relying solely on information already available to IRS.
- **Correspondence.** These will be less intrusive correspondence exchanges with taxpayers – rather than the old standard of sit-down audits. About 9,000 returns will be included in this process.
- **Less intrusive audits.** Instead of the old “line-by-line” examination approach, the IRS will gather more information beforehand from agency records and focus only on selected parts of approximately 30,000 returns.
- **Calibration audits.** These will consist of about 2,000 examinations that will check each line of the return. But, in a major change from earlier programs, taxpayers will not be required to provide line-by-line substantiation.